

The Portfolio

The Next Asset Bubble

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Gaze out your window at the cars going by. Now pretend you will be paid a quarter every time one passes.

These days, the world's largest investors are making similar calculations, and they like what they see. Stable cash flow is something to cherish, with volatility whipsawing stocks and the debt market nursing the sting of billions in collateralized debt obligations gone awry. So the once-sleepy backwater of infrastructure investment—the buying up of public roadways, utilities, airports, hospitals, and even prisons—has become fertile ground for Wall Street titans.

The problem is that the chief benefit of the investment—a safe long-term inflation-adjusted return—becomes harder to reach as more investors pile into the market seeking it.

Experts worry that prices have already been driven too high for many of the best assets. As evidence, they note that more deals are being loaded up leveraged-buyout levels of debt. At the same time, yield-hungry investors are increasingly willing to build or buy infrastructure in riskier corners of the world.

Is infrastructure fated to become the next asset bubble? Ryan J. Orr, executive director of Stanford's Collaboratory for Research on Global Projects, says: "We're already there."

Such concerns aren't stopping the party. Financial-services companies continue to flood the market with new infrastructure funds and new ideas about putting these funds to work. Some of those new ideas involve less-traditional assets like lotteries, gas stations, and old folks homes.

Stanford's Collaboratory estimates that more than 72 new infrastructure funds have been introduced since the beginning of 2006 and that more than \$160 billion has been raised during that period for infrastructure investment.

Robert Dove, co-manager of Carlyle Infrastructure Partners, said new funds are cropping up because "there is certainly an appetite in the investment community for more stable, predictable investments." He adds that Carlyle, which closed its first infrastructure fund in November after raising almost \$1.2 billion in about 18 months, sees "great opportunities" in the sector.

It's an opportunity based on hard times, as governments around the world will have difficulty paying for what is estimated to be \$53 trillion in needed infrastructure investment over the next 25 years. This leaves the door open for private investors to offer a helping hand—for a price.

At the same time, some of private equity's biggest clients, pension funds and other institutional investors, are looking at the possibility that one day they might not meet growing needs going forward. Underfunded pension plans in the United States currently have liabilities of more than \$1.2 trillion but assets of only \$875 billion. Infrastructure investment is seen as playing an integral role in helping to close this gap.

"Our bottom line always has been and will be to maximize investment returns and thereby minimize contributions needed to fund our retirement benefits for 1.5 million members," says Clark McKinley, a spokesman for the California Public Employees' Retirement System, which earmarked \$2.5 billion for infrastructure investment last month.

He adds that the people served by his fund, which is known as Calpers, depend on investment returns for 75 cents of every dollar they receive. "Prudent, smart infrastructure investments may help us sustain those kind of returns for the benefit of our people and other Californians," he explains.

But the easy money may have already been made by old hands like Macquarie Bank, the Australian company that pioneered the idea of the infrastructure fund in the early 1990s. It now controls billions of dollars worth of airports, toll roads, ports, and utilities.

When Macquarie got into the field, financial sponsors, like pension funds and private equity groups, accounted for only about 6 percent of infrastructure purchases. Now they measure closer to 20 percent. And, instead of partnering up, they're often competing madly against each other.

Calpers, for instance, says it is considering making direct investments in infrastructure assets, instead of buying through another sponsor like a private equity fund. Other pension funds have already entered the fray, competing directly with sovereign wealth funds, endowments, and their former advisers in the private equity and investment-banking world.

"We made a decision around 2002 to focus on direct investment," says Stephen Dowd, Ontario Teachers' Pension Plan's vice president for infrastructure investments, adding that many other pension funds have also benefited from the approach. "They all have strong teams, are able to compete, and are in fact ahead of the game when compared with a lot of the third party funds."

Unfortunately, all this competition is diluting returns from infrastructure investments for everyone involved, contributing to an increase in both the multiples being paid for assets and the aggressive financial leverage being used to fund them.

Standard & Poor's notes that while the number of global infrastructure deals increased 24 percent between 2005 and 2007, the value placed on those deals increased by 90 percent as investors offered more and more for less and less.

To take one example, regulated water companies in Britain fetch well over a 25 percent premium to their asset value.

"Some of these multiples are scary," says Orr, noting that funds "promising high double-digit returns on brownfield buy-outs—where they buy assets, lever them up with debt, do some fancy financial engineering and packaging—are never going to be able to achieve those aggressive performance targets."

Bidding wars have raised the level of risk to a point where investors like Stephen Dowd have become more cautious, forcing him to sometimes walk away from a deal.

"It's more of a challenge now and you have to be disciplined about the pricing of risk," Dowd says. "If you lose to someone who prices it differently, you have to just go on to the next one." The Ontario Teachers' Pension Plan currently has about 7 percent of its \$103.6 billion in net asset in infrastructure investments.

Not everybody is dialing back the danger. There is too much new money sloshing around in the sector, much of it destined for marquee purchases and all of it needing to be put to work.

Some investors, hoping to avoid inflated prices in Europe and in the United States, are now looking to emerging markets, where infrastructure investment has been rising at a fast clip. More than \$56 billion was spent on Russian infrastructure in 2007, compared with only \$3.9 billion the year before, for example.

Other investors are taking what could be an even bigger gamble, partnering with construction companies to build the infrastructure of the future—known as greenfield developments—instead of bidding on what already exists.

All of these investors can draw comfort from reams of data projecting the risks and the rewards inherent in their decisions. But the world can change quickly and forecasting gets a lot harder the further out you go.

Just ask the investors who were forced to renegotiate Latin American infrastructure investments in the 1990s; those caught short when the Eurotunnel linking England and France defaulted on its debt; or anyone hit by boycotts of their sparkling new toll roads.